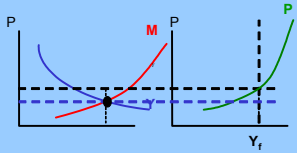
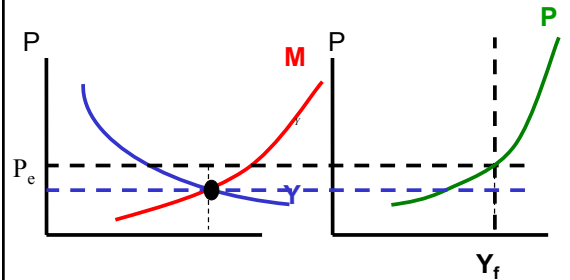


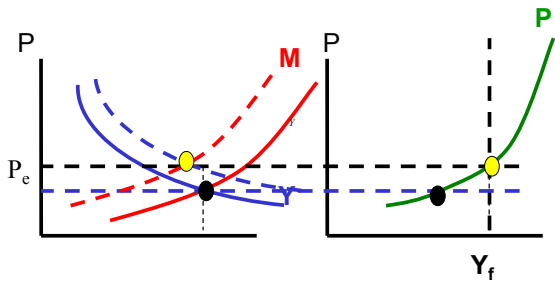
Managing Monetary Policy



Monetary Policy 101



Monetary Policy 101



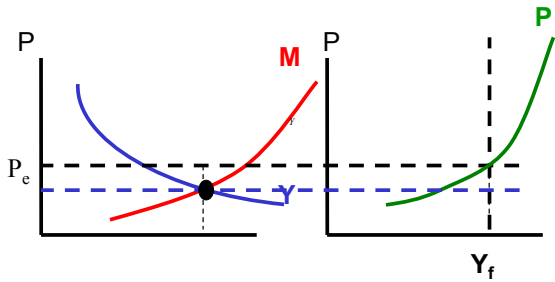
Issues

- How do you know Equilibrium
- The Costs of Error
- The Perils of Targeting Interest Rates
- Credibility
- Monetary Policy Rules

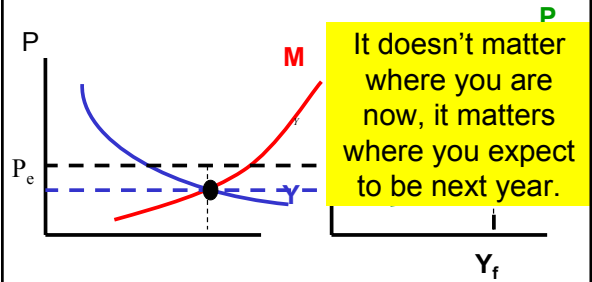
How Do You Know
Equilibrium?

Before you decide where you
want to go, you better know
where you are

Monetary Policy 201

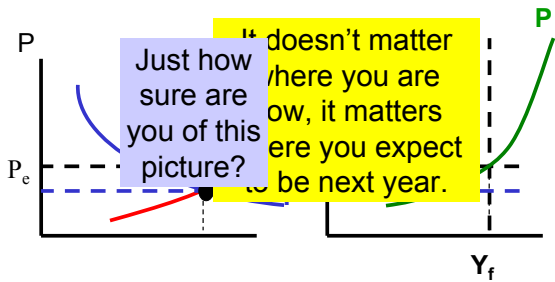


Monetary Policy 201



It doesn't matter where you are now, it matters where you expect to be next year.

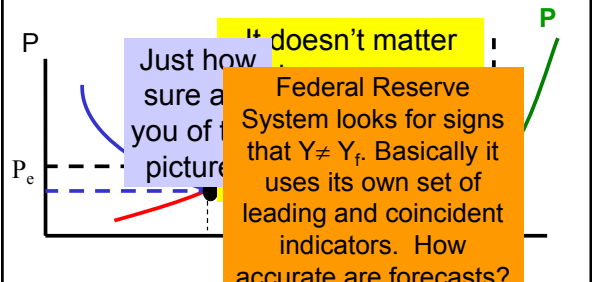
Monetary Policy 201



Just how sure are you of this picture?

It doesn't matter where you are now, it matters where you expect to be next year.

Monetary Policy 201



Just how sure are you of this picture?

It doesn't matter where you are now, it matters where you expect to be next year. Federal Reserve System looks for signs that $Y \neq Y_f$. Basically it uses its own set of leading and coincident indicators. How accurate are forecasts? Not great.

Suppose you are Wrong

What happens if you err?

- If you have an omniscient Chairman, then sleep tight, for $Y=Y_f$. Always.

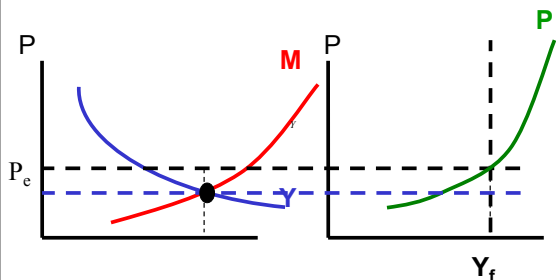
What happens if you err?

- If you have an omniscient Chairman, then sleep tight, for $Y=Y_f$. Always.
- To be more precise, we can assure that there are no deviations between η and η_e
- No business cycles due to imperfect information.

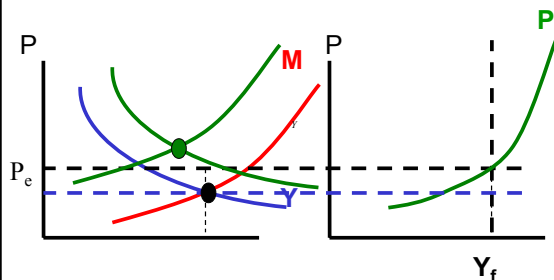
What happens if you err?

- If you have a mere mortal as Chairman, then
 - Sometimes the gap between η and η^e will be narrowed.
 - Sometimes the gap will be increased.

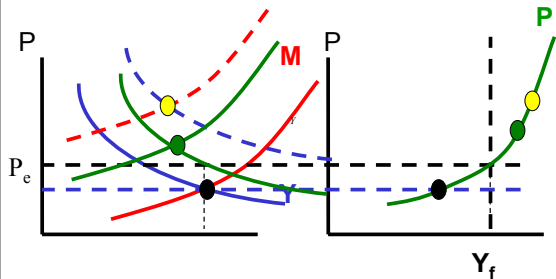
The Fed's Picture of Next Year



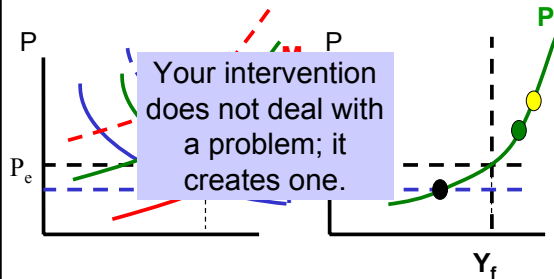
The Reality



Oops

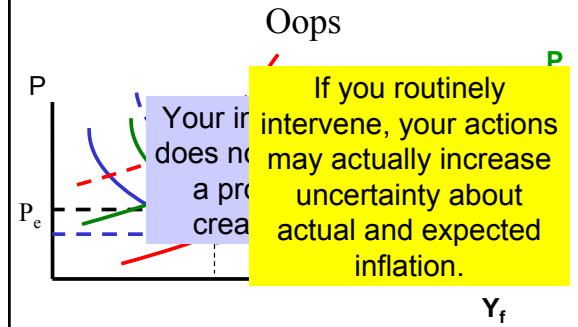


Oops



Your intervention does not deal with a problem; it creates one.

Should the Chairman of the Federal Reserve System play more golf?



Two Track Records

Interventions	10
Made the situation better (narrowed the gap between Y and Y_f)	7
Made the situation worse (increased the gap between Y and Y_f)	3

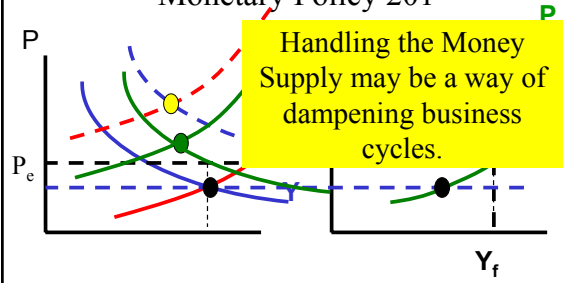
Two Track Records

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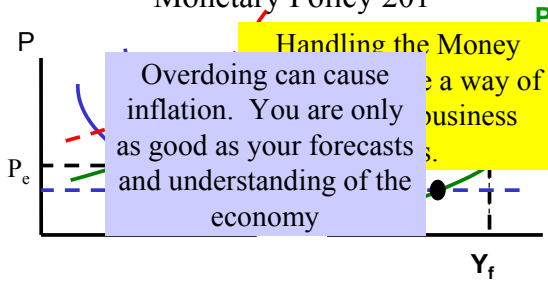
Two Track Records

Interventions	10
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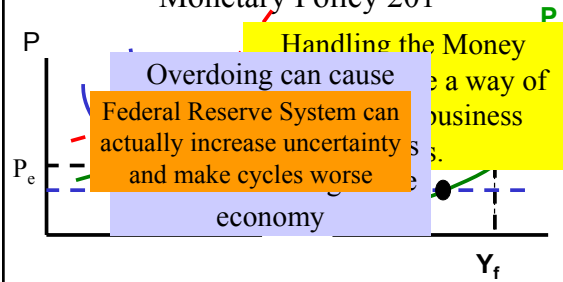
The Final Exam, Monetary Policy 201



The Final Exam, Monetary Policy 201



The Final Exam, Monetary Policy 201



Monetary Policy 301

- You are the humble chairman of the Federal Reserve System.
- You know what you know and what you don't know.
- In particular...

Monetary Policy 301

- In particular...
- A 90% chance that the economy is ok and the right policy is for no intervention.
- A 10% chance that the economy is headed for a rough time period.

Monetary Policy 301

- If you add money and are wrong (90% chance)
- You create some inflation

Monetary Policy 301

- If you add money and are wrong (90% chance)
- You create some inflation
- If you don't add money are wrong (10% chance)
- You can see major problems

Conclusion

*Just because you can do something
in theory doesn't mean you will do
so in practice.*

Conclusion

*And sometimes you may want to
take insurance and do what you
probably think is the wrong thing.*

End

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